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ADJUSTING FOR DEPRECIATION CLAIMED IN ERROR

— by Neil E. Harl*

Occasionally, depreciation is claimed at a rate that is more rapid than allowed by the Modified Accelerated Cost Recovery System and once in a great while depreciation is claimed at a slower rate.[1] IRS now provides guidance on how to handle the adjustments for income tax reporting purposes in both situations.[2] While there are similarities, the two sets of procedures differ significantly.

Too much depreciation claimed

If too much depreciation has been claimed, approval of the Commissioner of Internal Revenue is required, a Form 3115 must be filed and a positive adjustment must be made for the excess depreciation claimed.[3] A user fee is levied for the change. The rules were included in a lengthy revenue procedure issued in 1992 governing changes in accounting generally.[4]

Too little depreciation claimed

In 1996, IRS issued guidance on the procedure to follow if too little depreciation has been claimed.[5] The consent of the Commissioner of Internal Revenue is required, since it involves a change in accounting method.[6] A Form 3115 must be filed within 180 days after the beginning of the year in which the proposed change is to be made.[7]

The revenue procedure is specifically made non-applicable to several situations— (1) property held by tax-exempt organizations; (2) most intangible property; (3) property involving an amortization election; (4) where a change only is made in the estimated useful life of property;[8] (5) property for which the use is changed but it continues to be owned by the same taxpayer; (6) property for which too much depreciation has been claimed; (7) property being shifted from being expensed to being capitalized; (8) any change in method of accounting for depreciation purposes; and (9) any change in method of accounting (other than related to depreciation).[9]

In instances where too little depreciation has been claimed, the consent of the Commissioner is automatic[10] if a Form 3115 is filed with the National Office of IRS.[11] In addition, a copy of the Form 3115 is to be attached to the taxpayer's timely filed return (including extensions).[12] The taxpayer should type or print at the top of the Form 3115, "AUTOMATIC METHOD CHANGE UNDER REV. PROC. 96-31."[13] No user fee is required for a Form 3115 filed when too little depreciation has been claimed.[14]

The entire negative adjustment from the change must be taken into account in computing the taxable income for the year of change.[15] An appropriate adjustment in income tax basis for the property is required.[16]

Meaning of depreciation allowable

Rev. Proc. 96-31 also contains guidance on what is meant by "depreciation allowable."[17]

• For pre-recovery property,[18] the term means the depreciation allowable under the depreciation method adopted by the taxpayer or, if that does not result in a reasonable allowance for depreciation, the straight line method.[19]

• For MACRS property,[20] the depreciation allowable is determined by using either the general depreciation system[21] or the alternative depreciation system if use of that system is required.[22]

• For amortizable intangible property, the depreciation allowable is calculated using straight line amortization over a 15-year period.[23]

FOOTNOTES

1 See generally 4 Harl, *Agricultural Law* Ch. 29 (1996); Harl, *Agricultural Law Manual* § 4.03[4] (1996).
2 Rev. Proc. 92-20, 1992-1 C.B. 685 (too much depreciation claimed); Rev. Proc. 96-31, I.R.B. 1996-20 (too little depreciation claimed).
3 Rev. Proc. 92-20, 1992-1 C.B. 685. See I.R.C. § 484(a).
4 Rev. Proc. 92-20, 1992-1 C.B. 685.
5 Rev. Proc. 96-31, I.R.B. 1996-20.
6 *Id*., Sec. 1.
7 *Id*., Sec. 2.02.
8 A change in estimated useful life of depreciable property must be made prospectively. Treas. Reg. § 1.167(b)-2(c).
9 Rev. Proc. 96-31, *supra* n. 5, Sec. 3.
10 *Id*., Sec. 4.01.

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[11] *Id*., Sec. 5.01. The original of the Form 3115 must be filed with: Office of Associate Chief Counsel (Domestic); Commissioner of Internal Revenue; ATTN: CC:DOM:P&SI:6; Room 5112; P.O. Box 7604; Ben Franklin Station; Washington, DC 20044.
[12] Rev. Proc. 96-31, supra note 5, Sec. 5.01(1).
[13] *Id*., Sec. 5.01(2).
[14] *Id*., Sec. 5.01(3).
[15] *Id*., Sec. 5.04(3).
[16] *Id*., Sec. 5.05.
[17] Rev. Proc. 96-31, *supra* n. 5, Sec. 7. The depreciation adjustment to basis is the amount allowable, not the amount claimed. Brock v. Comm'r, T.C. Memo. 1994-177 (calculation of gain on foreclosure sale of rental property).
[18] See I.R.C. § 167.
[19] Rev. Proc. 96-31, *supra* n. 5, Sec. 7.02.
[20] See I.R.C. § 168.
[21] I.R.C. § 168(a).
[22] I.R.C. § 168(g). See Rev. Proc. 96-31, *supra* n. 5, Sec. 7.03.
[23] Rev. Proc. 96-31, *supra* n. 5, Sec. 7.04.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-*ALM* § 13.03.*

AVOIDABLE LIENS. The debtor, a ranch partnership, purchased cattle from a dealer on installment, with the debtor granting the dealer a purchase money security interest in the cattle. The security interest was later amended because of a change in the brand on the cattle. The dealer filed the security interest with the Secretary of State instead of the proper place in the county recorder's office. The debtor later borrowed funds from a bank and granted the bank a security interest in all livestock. The bank searched the state and county records and discovered the dealer's security interest at the state office but not the county office. Although the bank could have obtained a copy of the security interest from the state, the bank did not ask for a copy. The dealer obtained a court order to turn over 195 cows and 25 heifers within 90 days before the Chapter 12 bankruptcy filing. The debtor-in-possession sought to avoid the dealer's security interest in the cattle as unperfected and to avoid the court order transferring the cattle to the dealer. The court held that the security interest was not perfected because it was not filed with the county recorder; therefore, the debtor-in-possession could avoid the security interest. The dealer argued that the court-ordered transfer of the cattle was not preferential because of the new value given for the order in that the dealer had allowed a hearing to continue in exchange for the transfer order. The court held that the court-ordered transfer was an avoidable transfer because the hearing delay was not sufficient new value for the transfer. The bank sought to have its security interest given first priority in the cattle after the avoidance. The court held that, because the bank had knowledge of the dealer's security interest, even though improperly filed, the bank could not assert a priority security interest; therefore, the debtor-in-possession had a priority security interest in the cattle by means of the avoidance of the dealer's security interest. ***In re* Double J Cattle Co., 203 B.R. 484 (D. Wyo. 1995)**.

EXEMPTIONS

CASH. The debtor claimed cash on hand as exempt tangible personal property under Ind. Code § 34-2-28-1(a)(2). The trustee objected, arguing that money was an intangible subject to exemption only under Ind. Code § 34-2-28-1(a)(3). The court reviewed Indiana law and held that cash was tangible personal property when held by the debtor and eligible for exemption as tangible property. **Levin v. Dare, 203 B.R. 137 (S.D. Ind. 1996)**.

CHAPTER 12-*ALM* § 13.03[8].*

DISCHARGE. The debtor had granted a second mortgage to the FmHA (now FSA) on real property. The FmHA's lien was divided into a secured claim and unsecured claim in the bankruptcy case, based on the fair market value of the property at the confirmation of the plan. After the plan payments were completed, the FmHA objected to the payments on the unsecured claim and received additional payments in settlement of that claim. The debtor was granted a discharge and the case was closed. The debtor later died and the debtor's estate sold the property for substantially more than the value used in the bankruptcy case. The FmHA argued that it retained a lien against the property for the portion of the unsecured claim not paid in the bankruptcy case. The FmHA cited *Dewsnup v. Timm, 502 U.S. 410 (1992)* in support of its argument that its lien was not "stripped" as to the unsecured portion. The court held that *Dewsnup* did not apply to Chapter 12 cases where the "stripping" of liens was allowed by Section 1222(b)(2); therefore, at the discharge of the debtor, the FmHA lien was extinguished. The appellate court affirmed, noting that the Chapter 12 plan specifically provided for extinguishment of the FmHA lien upon payment of all plan secured and unsecured claims. **Harmon v. U.S., 101 F.3d 574 (8th Cir. 1996), *aff'g*, 184 B.R. 352 (D. S.D. 1995)**.

PLAN. The debtors' Chapter 12 plan provided for payment of a secured claim owed to a Farm Credit Bank over the life of the plan at 7.5 percent interest. The original loan had an interest rate of 8.75 percent. The Bankruptcy Court did not confirm the plan because the interest rate was less than the prime rate plus 1.5 percent for the risk factor, given the debtor's poor repayment